

International Secured Transactions and Insolvency

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I. New Developments in Sovereign Insolvency: *NML Capital, Ltd. v. Republic of Argentina*, 727 F. 3d 230 (2d Cir. 2013), *cert. den.*, 134 S.Ct. 2819 (2014)

On June 16, 2014, the U.S. Supreme Court denied the Republic of Argentina's petition for *certiorari*¹ challenging the Second Circuit Court of Appeals' (the "Second Circuit's") decision² upholding the right of plaintiff-appellee NML Capital ("NML Capital" or "the plaintiff") to the equal treatment of its Fiscal Agency Agreement ("FAA") bonds that had not been tendered in either bond exchange offered by the Republic of Argentina in 2005 and, again, in 2010. Bonds issued in the bond exchanges are called the "Exchange Bonds." NML Capital, a hedge fund, argued successfully that its FAA bonds had to be paid ratably if the Exchange Bonds were paid.

At its core, the case was a contract law dispute. NML Capital sought enforcement of the express contract language set forth in its bonds. The operative language is the *pari passu* or equal treatment clause³ which stated in pertinent part:

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1. Republic of Argentina v NML Capital, Ltd., 134 S. Ct. 2819 (2014). On the same day, the Supreme Court issued a decision in the same case holding that the U.S. Foreign Sovereign Immunities Act does not limit the power of a court to order worldwide post-judgment discovery. Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 2250 (2014).

2. NML Capital, Ltd. v Republic of Argentina, 727 F.3d 230, 237 (2d Cir. 2013).

3. A great deal has been written about NML Capital, Ltd. v. Republic of Argentina, *supra* n. 1. See, e.g., W. Mark C. Weidmeyer and Anna Gelpert, *Injunctions in Sovereign Debt Litigation*, 31 YALE J. ON REG. 189 (2014); Brett Neve, NML Capital, Ltd. v. Republic of Argentina: *an Alternative to the Inadequate Remedies Available Under the Foreign Sovereign Immunities Act*, 39 N.C. J. INT'L & COM. REG. 631 (2014) (providing a

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The Securities will constitute the direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness. . .⁴

The Second Circuit upheld the literal meaning of the *pari passu*/equal treatment clause which required that the Argentine government pay those bonds held by the plaintiff on the same basis as it pays those bondholders holding the Exchange Bonds. The impact, said the Court, was that the plaintiff had a ratable right to payment of its bonds, plus accumulated interest, just as the Exchange Bond holders had a right to their payments.

Although \$1.4 billion in debt held by NML and over \$50 billion in Exchange Bond debt were at issue,⁵ the Second Circuit rejected the Argentine government's urging that it take into account the systemic problems that its decision might create for sovereign debtors. It held that the Argentine government had failed to produce sufficient evidence that these problems would occur, and that in any event, in its case the systemic problems were "almost entirely of [its] own making."⁶ The Court, therefore, issued an injunction that essentially gives the Argentine government a choice: it can pay NML all or a portion of its FAA bond obligations and pay the Exchange Bonds ratably, or it can continue in default on NML's FAA bonds and default on the Exchange Bonds.⁷

The Argentine government has vowed not to pay the Exchange Bonds, but third parties involved in paying them risk liability for abetting contempt of court if they participate in paying the Exchange Bonds without payment of NML's bonds.⁸ Consequently, Argentina has gone into default on virtually all of its bonds since the decision.⁹

There is no clear resolution to the dispute in sight. The hold-out bondholders have not been willing to settle. The Argentine government has a duty to the citizens who elected it into office to avert economic ruin if possible, but the effect of nonpayment on the Argentine economy is projected to be a significant economic contraction.¹⁰

The implications of *NML Capital, Ltd. v. Republic of Argentina* for the systemic problems of sovereign state insolvency are not limited to Argentina.¹¹ The case can be understood as a wake-up call to governments that legal defenses are no panacea for fiscal irresponsibility.

good detailed summary of the underlying facts); Gregory Day, *Market Failure, Pari Passu, and the Law and Economics Approach to the Sovereign Debt Crisis*, 22 TULANE J. INT'L & COMP. L. 226 (2014).

4. *NML Capital, Ltd. v. Republic of Arg.*, 699 F.3d 246, 251 (2d Cir. 2012); cf. Lee C. Buchheit and Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 873 (2004).

5. Weidemeyer and Gelpert, *supra* n. 3 at 215.

6. *NML Capital, Ltd. v. Republic of Argentina*, *op. cit.*, at 246.

7. *NML Capital, Ltd. v. Republic of Argentina*, *op. cit.*, at 237.

8. Day, *supra* n. 3 at 243.

9. *Argentina Default Spreads To PAR Bonds, Risking Payment Demands*, REUTERS (October 31, 2014,) available at <http://www.reuters.com/article/2014/10/31/us-argentina-debt-idUSKBN0IK16W20141031>.

10. *Id.* (projecting a 2.6% contraction in Argentine GDP if the default is not cleared before October 2015 presidential elections).

11. See, e.g., Philip R. Wood, *How the Greek Debt Reorganisation of 2012 Changed the Rules of Sovereign Insolvency*, 14 BUS. L. INT'L. 3 (2013); Christian Hofmann, *Sovereign-Debt Restructuring in Europe Under the New Model Collective Action Clauses*, 49 TEX. INT'L L.J. 385 (2014).

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II. Mexican Developments in Secured Transactions and Insolvency: the 2014 Financial Reform

The 2014 Mexican Financial Reform,¹² part of a series of reforms intended to promote investment and economic growth, encompassed the amendment of more than 30 statutes, as well as issuance of a new Financial Groups Law (*Ley para Regular a las Agrupaciones Financieras*). This part will focus on the provisions of the Financial Reform pertaining to secured transactions and bankruptcy.

A. NEW SUMMARY MEANS OF ENFORCING SECURED TRANSACTIONS

Before the Financial Reform, the Mexican Commercial Code recognized certain documents with executory character allowing creditors to claim payment through a summary commercial action if those documents were issued by a notary public, granting the possibility of enforcing them as executory instruments. However, unless these documents met certain formalities required by article 1166, the creditor could not commence the summary action. Although article 1166 is still in full force and effect, the Financial Reform effectively eliminated the need for these formalities by providing in article 1391 that a notarized public deed showing a past due liquidated amount shall suffice for bringing a summary action.

Another provision of the Financial Reform amended the General Negotiable Instruments and Credit Operations Act to authorize the enforcement of a guaranteed obligation against cash of the debtor in the possession of the creditor without the necessity of filing a claim or commencing an enforcement proceeding. Prior to the Financial Reform, it was possible to pledge cash to guarantee payment of a debt, but the pledge could not be enforced without an enforcement proceeding. Now, it is deemed that the cash was transferred upon prior agreement of the parties for paying the debt rather than as pledge enforcement.

An additional change in the Financial Reform concerned a decentralized consumer financial protection agency named *Comisión Nacional para la Protección y Defensa de los Usuarios Financieros* (“CONDUSEF”). CONDUSEF has authority to act as an arbitrator between financial institutions and their customers and to resolve controversies by issuing an award. The Financial Reform rendered these awards binding executory documents. In addition, CONDUSEF is entitled to issue opinions if it deems that the customer has grounds for prevailing on its claim, which now are considered binding executory documents as well; previously they were merely considered evidence in subsequent proceedings.

B. BANKRUPTCY LAW REFORMS

Under prior law, major reorganization (*concurso*) proceedings were conducted indefinitely by the courts and with a lack of transparency and improper conduct, which led to uncertainty about the debtor’s real financial situation for unsecured creditors, and therefore to a lack of confidence in the proceedings. The Financial Reform amended the Bankruptcy Law to protect creditors, as follows:

12. Published in the Mexican Federal Official Gazette on January 10, 2014, and effective the following day.

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- Limiting the mediation phase to 185 calendar days following the last publication of the extract of the *concurso mercantil* ruling in the Federal Official Gazette;
- Implementing an electronic filing system;
- Making it possible for a business group to file for *concurso mercantil* of different entities, whenever they respectively control or are under control of a holding company subject to *concurso*; in that case each corporation shall keep its corresponding estate independent from the others;
- Making it possible to file for *concurso mercantil* if a general default is imminent within 90 days after filing.
- Making it possible to file for *concurso mercantil* directly at the bankruptcy stage, without having to exhaust the mediation stage;
- Expressly authorizing the court to issue interim measures at any stage of the proceedings;
- Making it possible for the insolvent entity to execute new credit agreements whenever they are deemed and approved as indispensable for its regular operation and its cash-sufficiency during the course of the proceedings;
- Making it possible to extend the retroactive period up to three years.
- Creating a new type of creditors with subordinated character, in which are included all those credits executed as inter-company debt; and
- Including new sanctions and criminal conducts against officers and “relevant” employees.

III. International Secured Transactions Update

In addition to the Mexican reforms discussed above, the following are changes in secured transactions laws of non-U.S. countries in the past year:

A. RUSSIA

The new Russian Pledge Law,¹³ parts of which became effective on July 1, 2014, was drafted with assistance from the European Bank for Reconstruction and Development and UNCITRAL. It includes the following features: (1) registration of non-possessory pledges by notaries, with registration conferring priority over conflicting claims to the collateral; (2) notice filing, with no need to register the pledge agreement or specifically describe the collateral; (3) syndication of secured loans; and (4) extra-judicial enforcement of creditors’ rights in the collateral.

Russia is one of the last former Soviet Union and “Eastern Bloc” countries to modernize its laws regarding secured transactions. Other countries to have done so include Albania, Armenia, Azerbaijan, Bosnia, Bulgaria, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Poland, Romania, Serbia & Montenegro, Slovak Republic, and Ukraine.¹⁴

13. Federal Law No. 367-FZ “On Amendments to Part I of the Civil Code of the Russian Federation and Repeal of Certain Legal Acts (Provisions of Legal Acts) of the Russian Federation,” signed by the President of the Russian Federation on 21 December 2013.

14. For a helpful comparison of the secured transactions laws of some of the former Soviet Union and “Eastern Bloc” countries, see Tibor Tajti, Post-1990 Secured Transaction Law Reform in Central and Eastern

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B. LATIN AMERICA AND THE CARIBBEAN

Apart from Mexico, discussed elsewhere in this article, several other Latin American and Caribbean countries have had new developments in secured transactions law during the past year.

Costa Rica enacted a new secured transactions law based largely on the Organization of American States Model Interamerican Law on Secured Transactions (“OAS Model Law”) on May 20, 2014, but has yet to implement it.¹⁵ Colombia and El Salvador enacted similar laws in 2013, and Colombia’s secured transactions registry, the *Registro de Garantías Mobiliarias*, became operational in May 2014. At this writing (late 2014), Ecuador and Nicaragua are also considering adoption of the OAS Model Law.

The Colombian law¹⁶ permits all types of movable assets, present and future, to be used as collateral. It provides for notice filing in a unified collateral registry. It regulates legal instruments that are the functional equivalents of traditional security interests, such as seller’s retention of title. It establishes the rights and priority of secured claims within bankruptcy proceedings, and allows non-judicial enforcement of secured creditors’ interests in collateral.

Jamaica also adopted a new secured transactions law¹⁷ in 2013, but unlike Colombia did not quickly proceed with implementation. Rather, in 2014 it initiated with the OAS a process of determining how the law would be implemented. Like Colombia’s, the Jamaican law is based on the OAS Model Law. It broadens the range of assets usable as collateral, allows a general description of the collateral and notice filing, and establishes a modern, unified collateral registry.

Panama made similar changes¹⁸ and also allowed non-judicial enforcement of secured creditors’ interests in collateral.

Brazil enacted reforms in its secured transactions enforcement laws, allowing secured creditors for the first time to enforce their interests in movable property without resort to judicial process. However, Brazil made no other changes, leaving in place what otherwise has been regarded as a dysfunctional system in need of reform.

Trinidad and Tobago in 2014 expanded the range of assets that can be used as collateral.

C. EUROPE

One of the most interesting new developments in international secured transactions law in 2014 took place in Belgium, long one of the least hospitable countries for secured transactions in movable property. With the enactment of new legislation,¹⁹ Belgium is now poised to modernize its secured transactions legal regime by implementing a new

Europe, Szegedi Közigazgatási Közlöny. 2013;II(3-4):1-18, available at <http://publications.ceu.hu/sites/default/files/publications/2-only-tajti-article-szkkozlony-3-4-2013-english.pdf> (last visited December 5, 2014).

15. *Ley de Garantías Mobiliarias del 20 de mayo de 2014*.

16. *Ley No. 1676 del 20 de agosto de 2014*, “Por la cual se promueve el acceso al crédito y se dictan normas sobre garantías mobiliarias.”

17. Security Interests in Personal Property Act (2013).

18. *Ley 129 de 31 de diciembre de 2013*.

19. “Loi modifiant le Code Civil en ce qui concerne les sûretés réelles mobilières et abrogeant diverses dispositions en cette matière,” 11 July 2013. See I Peeters and M de Muynck, *Belgium moves to modernity but only half way: the introduction of new legislation on security interests in movable assets*, 29 JIBFL 75 (2014).

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system to some extent influenced by the UCC Article 9 system that would require registration of non-possessory pledges of movable property, both tangible and intangible, in a national online registry. Pledges would be subject to written security agreements describing the collateral, and priority would be according to a first-to-register rule. However, registration would have to be accomplished through a notary.

Elsewhere in Europe, the Czech Republic amended its Civil Code²⁰ to make it possible to register pledges of receivables at its Pledge Registry. It also made it possible for the parties to a security agreement to agree to non-judicial enforcement of the secured creditor's interest in the collateral. Hungary also expanded the range of assets that can be used as collateral and made other changes in its secured transactions laws.²¹

D. ASIA

The Lao PDR (Laos) established a modern notice-based collateral registry in November 2013 pursuant to 2005 legislation and a 2011 decree.²² The registry is online, available to financial institutions, and can be used to register any kind of security interest in movable property, including functional equivalents of security interests such as financial lease agreements, assignments of receivables, fiduciary transfers of title and sales with retention of title.

Afghanistan adopted a new secured transactions law in 2013.²³ The law was based on the Albanian secured transactions law, which in turn had been modelled on the Canadian Personal Property Security Act (PPSA).

E. AFRICA

Malawi, Rwanda and Liberia have all enacted modern secured transactions laws based in part on the UCC or the New Zealand or Canadian Personal Property Security Acts ("PPSA"s), which themselves were derived directly or indirectly from the pre-1999 version of UCC Article 9. Malawi enacted its PPSA in July 2013. All of these countries recently implemented new collateral registries with the help of the International Finance Corporation. In 2014 Rwanda also strengthened the rights of secured creditors in reorganization proceedings.

F. PACIFIC ISLANDS

As of mid-2014, several of the 13 Pacific island nations have already reformed their secured transactions laws based on the UCC model, with assistance from the Asian Development Bank and the International Finance Corporation. These include Vanuatu, Micronesia, the Solomon Islands, Palau, Tonga, and the Marshall Islands. Papua New Guinea and Samoa have enacted new secured transactions laws but are currently awaiting imple-

20. Law No. 89/2012 Coll. Civil Code, Part V, Section 3, eff. January 1, 2014.

21. Civil Code of 2013, Act V, Fifth Book, Part V, Title VII, Chapters XXI-XXVIII, available at http://ptk2013.hu/wp-content/uploads/2013/03/uj_ptk_szov.html.

22. Registry Office For Security Interests In Movable Property, LAOTIAN MINISTRY OF FINANCE, http://www.mof.gov.la/str/file/Information_Guide_English.pdf.

23. *Law For Secured Transactions On Movable Property In Banking Transactions*, http://dab.gov.af/Content/Media/Documents/Secured_Transaction_Law_English_06Jan102412201318485013553325325.pdf.

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mentation of modern registries. A new secured transactions law is under consideration in Fiji.

G. CAPE TOWN CONVENTION

The Cape Town Convention on International Interests in Mobile Equipment²⁴ came into force in 2001 as to its protocol on aircraft, covering large aircraft equipment.²⁵ Two other protocols, on railway rolling stock and space assets, were drafted but have not been ratified by a sufficient number of states to come into force. In 2014, development of a fourth protocol, on agricultural, construction and mining equipment, was pending.²⁶

H. EFFECT OF MODERNIZATION OF SECURED TRANSACTIONS LAWS

Where a country has modernized its secured transactions laws according to the UCC or PPSA model, or where its laws otherwise satisfy the standards set in UCC § 9-307(c), a creditor extending secured credit to a person residing in that country or a non-U.S. entity maintaining its chief executive office in that country may have to register its security interest under the laws of that country for its security interest to have a priority that would be recognized in a U.S. court.²⁷ If the debtor's country's secured transactions laws do not satisfy the § 9-307(c) standards, the secured creditor normally would perfect its security interest in accordance with the laws of the District of Columbia, as the debtor is deemed, under the last sentence of that section, to be located there, and perfection in most types of collateral is governed by the law of the location of the debtor under UCC § 9-301(1).

IV. Technology Patent Cross-Licensing: Jaffe v. Samsung Electronics Co., Ltd., et al.

In October 2014, the United States Supreme Court denied a petition for a writ of *certiorari* in *Jaffé v. Samsung Electronics Co.*,²⁸ letting stand the December 2013 decision by the United States Court of Appeals for the Fourth Circuit that had held that the protections afforded to intellectual property licensees by § 365(n) of the Bankruptcy Code²⁹ apply in Chapter 15 cases.

24. Convention On International Interests In Mobile Equipment (2001), available at <http://www.unidroit.org/instruments/security-interests/cape-town-convention>.

25. Protocol To The Convention On International Interests In Mobile Equipment On Matters Specific To Aircraft Equipment (2001), available at <http://www.unidroit.org/instruments/security-interests/aircraft-protocol>.

26. See <http://www.unidroit.org/work-in-progress-studies/current-studies/mac-protocol>.

27. See Arnold S. Rosenberg, *Where to File Against Non-U.S. Debtors: Applying UCC §9-307(c)[Rev] to Foreign Filing, Recording and Registration Systems*, 39 U.C.C. L.J. 109 (2006); *idem.*, *Classification of Foreign Filing Systems*, in PRACTICE UNDER ARTICLE 9 OF THE U.C.C. (2012); Dayka & Hackett, LLC v. Del Monte Fresh Produce N.A., Inc., 269 P.3d 709 (Ariz. Ct. App. 2012).

28. *Jaffé v. Samsung Electronics Co.*, 737 F.3d 14 (4th Cir. 2013), *cert. denied*, No. 13-1324 (Oct. 6, 2014).

29. 11 U.S.C. § 101, *et seq.* (as amended, the "Bankruptcy Code").

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Under U.S. bankruptcy law, a debtor generally has a right to reject executory contracts that the debtor, in its business judgment, determines are burdensome.³⁰ That right is not unlimited. In certain circumstances, the debtor's rejection right may be restricted or conditioned. In the area of intellectual property, Section 365(n) provides that where a debtor licensor of intellectual property elects to reject that license, nevertheless the licensee may elect "to retain its rights (including a right to enforce any exclusivity provision of such contract) under such contract" subject to making any required ongoing payments.³¹ So under U.S. bankruptcy law, even where a debtor rejects an intellectual property license, the licensee has an opportunity to retain its rights under that rejected license.

By contrast, under German insolvency law, an insolvency administrator who determines that an intellectual property license is burdensome may not only elect not to continue to perform under the license (akin to a decision to reject the license), but may also terminate the licensee's right to use the intellectual property.³²

Qimonda AG ("Qimonda") is a semiconductor manufacturer, whose principle assets are approximately 10,000 patents, 4,000 of which are U.S. patents. Qimonda instituted a German insolvency proceeding, which was recognized as a foreign main proceeding under Chapter 15. In the German proceeding, Qimonda declared, under German law, that its patent licenses were no longer enforceable. In its Chapter 15 case, Qimonda then sought discretionary relief to terminate and relicense its U.S. patents.

Weighing the interests of Qimonda and the licensees, the bankruptcy court concluded that "the balancing of debtor and creditor interests required by § 1522(a), weighs in favor of making § 365(n) applicable to Dr. Jaffe's administration of Qimonda's U.S. patents."³³

Section 1506 of the Bankruptcy Code allows a court to deny a foreign representative's request if granting the request would be 'manifestly contrary to . . . public policy.'³⁴ Commentary to both Chapter 15 and the UNICITRAL Model Law on Cross-Border Insolvency advise that the public policy exception applies only in circumstances where a 'fundamental policy' is threatened. The bankruptcy court reasoned:

That the right of a non-bankrupt licensee to continue using a patent license was deemed by Congress to be of great public importance can scarcely be doubted. The legislative history is clear that Congress believed that allowing patent licenses to be terminated in bankruptcy would "impose[] a burden on American technological development." Moreover, the alacrity with which Congress acted [in adding section 365(n) to the Bankruptcy Code] following the *Lubrizol* decision is ample evidence of the seriousness with which it viewed the "threat to American Technology" raised by the holding of that case. The question before the court, however, is whether the policy that § 365(n) seeks to promote is *fundamental*.³⁵

30. Bankruptcy Code § 365(a) does not explicitly require burdensomeness. The determination whether rejection of an executory contract is advantageous to the estate is left to the business judgment of the trustee or debtor in possession. See *in re Orion Pictures, Inc.*, 4 F. 3d 1095, 1099 (2d Cir. 1993).

31. 11 U.S.C. § 365(n).

32. German Insolvency Code § 103 is similar to Bankruptcy Code § 365 but lacks an exception for licenses like § 365(n) that would limit their rejection.

33. *Id.* at 182.

34. 11 U.S.C. § 1506.

35. *Id.* at 184.

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The bankruptcy court held that the preservation of intellectual property licensee rights is a fundamental right, and concluded that for purposes of § 1506, “deferring to German law, to the extent it allows cancellation of the U.S. patent licenses, would be manifestly contrary to U.S. public policy.”³⁶

On appeal, the Fourth Circuit affirmed the bankruptcy court’s decision, stating:

[I]n weighing the respective interests of the Licensees and the debtor under § 1522(a), [the bankruptcy court] found that without the protection of § 365(n), the risk of harm to the Licensees would be very real, impairing the “design freedom provided [them] by the cross-license agreements.” . . . And as the bankruptcy court otherwise found, this potential harm to the Licensees would, in turn, threaten to “slow the pace of innovation” in the United States, to the detriment of the U.S. economy. . . . Thus, the court’s findings, which were, to be sure, focused on the Licensees’ interests, nonetheless necessarily furthered the public policy underlying § 365(n).³⁷

The Fourth Circuit refrained from holding that failing to apply § 365(n) would be “manifestly contrary” to U.S. public policy in all circumstances. “In this case,” the court held,

it is sufficient for us to affirm the bankruptcy court, based on its application of § 1522(a). But in doing so, we understand that, by affirming the bankruptcy court’s application of § 365(n) following its balancing analysis under § 1522(a), we also indirectly further the public policy that underlies § 365(n). The Senate Report accompanying the bill that became § 365(n) explicitly recognized that licensees have a strong interest in maintaining their right to use intellectual property following the licensor’s bankruptcy and that to deny them that right would ‘impose[] a burden on American technological development that was never intended by Congress.’³⁸

In *Jaffe*, the Fourth Circuit struck the balance between the interests of the parties that § 1522 requires, granting relief to a foreign representative, but only when and to the extent that the interests of other parties (including the debtor and creditors) are sufficiently protected. As policy, the decision supports innovation by refusing to unsettle the expectations on which the parties made their investment decisions. As law, the protective balancing required by § 1522 avoids an overly-specific, itemization of mandatory protections that would favor some and perhaps omit others.

V. Bankruptcy Code Section 550 Cannot Be Used to Recover Foreign Transfers to Foreign Subsequent Transferees

Following the December 11, 2008 arrest of Bernard L. Madoff for his operation of a Ponzi scheme through Bernard L. Madoff Investment Securities LLC (“BLMIS”),³⁹ liqui-

36. *Id.* at 185.

37. *Jaffe v Samsung Electronics Co., Ltd.*, 737 F.3d 14, 30 (4th Cir. 2013).

38. *Id.* at 32.

39. See *Picard v. Merkin et al.*, 515 B.R. 117, 117 (Bankr. S.D.N.Y. 2014) (giving detailed background of BLMIS in connection with decision on motion to dismiss third amended complaint against certain fraudulent transfer defendants).

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dation proceedings were initiated pursuant to the Securities Investor Protection Act (“SIPA”). BLMIS.⁴⁰ At the time of Madoff’s arrest, BLMIS managed approximately \$65 billion in customer funds, from which Madoff would make distributions to BLMIS customers from money invested by other BLMIS customers, claiming that such distributions were on account of investments in the stock market that ultimately proved to be fictitious.⁴¹ Since the commencement of the SIPA proceeding, Irving H. Picard, as Trustee for the liquidation of BLMIS (the “Trustee”), has aggressively sought recovery of funds on behalf of the SIPA estate from customers who received fictitious profits, i.e., more on their investments than the original principal they invested.⁴² As of October 15, 2014, the Trustee had successfully collected approximately \$9.84 billion of the nearly \$20 billion in stolen investments.⁴³

Notwithstanding the Trustee’s successful recovery strategies to date, three important decisions were issued in 2014 that suggest the litigation environment may be shifting in favor of the remaining BLMIS customers and away from the Trustee. At least one of those decisions had significant implications for international insolvency practitioners.

On July 6, 2014, the District Court for the Southern District of New York issued a decision rejecting the Trustee’s “unprecedented” attempt to expand U.S. bankruptcy law across borders when he sought to recover allegedly fraudulent transfers made from BLMIS’s offshore feeder funds to those funds’ institutional investors overseas.⁴⁴

A. BACKGROUND

Historically, so-called “feeder funds” pooled their own customers’ assets for investment in BLMIS.⁴⁵ As those feeder funds received distributions or withdrew money from BLMIS, they would, in turn, subsequently transfer such money to their own customers and managers. Many of these feeder funds had invested all or nearly all of their assets in BLMIS, so when BLMIS collapsed in late 2008, those funds similarly entered into liquidation proceedings in each of their home jurisdictions.⁴⁶

In addition to seeking to recover the allegedly avoidable transfers BLMIS made to its feeder funds, the Trustee sought to recover the subsequent transfers made by those feeder funds to their investors, as mediate or immediate transferees.⁴⁷ Defendant subsequent transferees moved to dismiss the Trustee’s complaints, based on the argument that Section

40. See generally *Sec. Inv. Prot. Corp. v. BLMIS*, Adv. Pro. No. 08-01789-SMB (Bankr. S.D.N.Y.).

41. *Id.*

42. The Bankruptcy Code permits the Trustee to recover or avoid prepetition transfers that “wrongfully reduce the pool of assets available to creditors.” *Picard v. Fairfield Greenwich Ltd., et al.*, 762 F.3d 199, 208 (2d Cir. 2014).

43. See generally <http://www.madofftrustee.com/> (Nov. 4, 2014).

44. *Sec. Inv. Prot. Corp. v. BLMIS*, 513 B.R. 222 (S.D.N.Y. 2014).

45. *Id.* at 225.

46. *Id.*

47. As a specific example, one defendant in the action, CACEIS Bank, a French *société anonyme* operating in France, invested funds with Fairfield Sentry Limited, a British Virgin Islands (“BVI”) company, and Harley International (Cayman) Limited, a Cayman Islands company. Both Fairfield Sentry and Harley were BLMIS feeder funds that are now in liquidation proceedings in the BVI and Cayman Islands, respectively. The Trustee alleged that he was entitled to recover approximately \$50 million from CACEIS, which CACEIS had received in recoverable subsequent transfers as a customer of Fairfield Sentry and Harley. *Id.* at 225-26.

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550 of the Bankruptcy Code does not apply extraterritorially and therefore does not reach the foreign subsequent transfers made by foreign feeder funds.⁴⁸

B. APPLICABLE LAW

Section 550(a) of the Bankruptcy Code permits the Trustee to recover “the property transferred [by a debtor] . . . to the extent that a transfer is avoided” under one of the Bankruptcy Code’s avoidance provisions.⁴⁹ Section 548(c) of the Bankruptcy Code allows a transferee who “takes for value and in good faith . . . [to] retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer.”⁵⁰

As held by the Supreme Court of the United States,⁵¹ there is a presumption against extraterritorial application of federal statutes, in order to “protect against unintended clashes between our laws and those of other nations which could result in international discord.”⁵² “In determining whether the presumption against extraterritoriality applies, the Court must apply the following two-part test:

- i) Determine whether the factual circumstances at issue require an extraterritorial application of the relevant statutory provision; and
- ii) If so, determine whether Congress intended for the statute to apply extraterritorially.⁵³

C. DISTRICT COURT HOLDING

The District Court held that the presumption against extraterritorial application was not rebutted in this case.⁵⁴

With respect to the first step in the analysis, the Court rejected the Trustee’s argument that “the application of any of the incorporated provisions of the Bankruptcy Code is inherently domestic,” and, instead, found that “a mere connection to a U.S. debtor, be it tangential or remote, is insufficient on its own to make every application of the Bankruptcy Code domestic.”⁵⁵ The Court stated that a straightforward reading of Section 550(a) requires a focus on “‘the property transferred’ and the fact of its transfer, not the debtor.”⁵⁶ Similarly, Section 548 also focuses on “the nature of the transaction in which property is transferred, not merely the debtor itself.”⁵⁷ Finally, the Court noted that the

48. *Id.* at 226.

49. 11 U.S.C. § 550(a); *see, e.g.*, 11 U.S.C. § 548(a)(1) (permitting a trustee to recover any fraudulent transfer made within two years before the petition date to the extent (A) such transfer was made with actual intent to defraud creditors, or (B) the debtor received less than reasonably equivalent value for such transfer and was insolvent or made insolvent by the transfer).

50. 11 U.S.C. § 548(c).

51. *See, e.g.*, *Morrison v. Nat’l Australia Bank Ltd.*, 561 U.S. 247, 130 S.Ct. 2869, 2877, 177 (2010).

52. *BLMIS*, 513 B.R. at 226 (quoting *EEOC v. Arabian American Oil Co. (“Aramco”)*, 499 U.S. 244, 248, 111 S.Ct. 1227 (1991)).

53. *Id.* (citing *Morrison*, 130 S.Ct. at 2877-88; *In re Maxwell Comm’n Corp. (“Maxwell I”)*, 186 B.R. 807, 816 (S.D.N.Y. 1995)).

54. *Id.*

55. *Id.* at 227.

56. *Id.*

57. *Id.*

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“transfers and transferees are predominantly foreign: foreign feeder funds transferring assets abroad to their foreign customers and other foreign transferees.”⁵⁸

When looking to the Congressional intent behind Section 550(a), the Court looked first to the language of the statute and noted that nothing therein suggested an intent for such statute to apply to foreign transfers.⁵⁹ The Court then rejected the Trustee’s arguments that Congressional intent may be implied because (i) the clear extraterritorial intent in Section 541(a)(1)⁶⁰ reflects that Congress could have clearly shown the same extraterritorial intent in Section 550(a) if it had so chosen,⁶¹ (ii) the relevant sections of SIPA were likewise unhelpful because “SIPA’s predominantly domestic focus suggests a lack of intent by Congress to extend its reach extraterritorially,”⁶² and (iii) while the Trustee’s policy argument that declining to apply 550(a) to foreign transfers would create a loophole in the law that “would allow a U.S. debtor to fraudulently transfer all of his assets offshore and then retransfer those assets to avoid the reach of U.S. bankruptcy law,” the Court noted that such a potential loophole must be balanced against the presumption against extraterritoriality and that the “Trustee here may be able to utilize the laws of the countries where such transfers occurred to avoid such an evasion while at the same time avoiding international discord.”⁶³

Finally, the Court held that, even if Section 550(a) could be applied extraterritorially, given the circumstances in this case, such an application would be inappropriate under the theory of international comity,⁶⁴ which requires that each applicable foreign jurisdiction be entitled to apply its “own rules concerning on what bases the recipient of a transfer from a debtor should be required to disgorge it.”⁶⁵

D. IMPLICATIONS

Judge Rakoff’s decision effectively precludes recovery by the Trustee in this case of billions of dollars in claims against foreign subsequent transferees. Moreover, his decision suggests that the presumption against extraterritoriality and considerations of international comity will preclude recovery in cases of transfers made on foreign soil between foreign non-debtors, particularly if the transferors are the subject of their own foreign insolvency proceedings. Although this may create a “loophole” inviting fraud on the part of U.S. debtors, it also protects foreign investors who may not otherwise have anticipated the application of U.S. law to their dealings with non-U.S. investment funds.

58. *Id.*

59. *Id.* at 228.

60. Section 541(a)(1) of the Bankruptcy Code defines property of a debtor’s estate to include certain specified property “wherever located and by whomever held.” 11 U.S.C. § 541(a)(1).

61. *BLMIS*, 513 B.R. at 229-30.

62. *Id.* at 230.

63. *Id.* at 231.

64. *Id.* at 231 (noting, “Comity ‘is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws’”) (quoting *In re Maxwell Comm’n Corp.* (“*Maxwell II*”), 93 F.3d at 1036, 1046 (2d Cir. 1996)).

65. *Id.* at 232.

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VI. Other Significant U.S. Insolvency Cases

A. OTHER MADOFF CASES

Two other Madoff cases should be noted. In one, *Picard v. Fairfield Greenwich Ltd., et al.*,⁶⁶ the Trustee for BLMIS attempted unsuccessfully to block settlements of investor class action lawsuits against feeder funds on the theory that the lawsuits were stayed by the automatic stay of Bankruptcy Code § 362(a). Notwithstanding the risk that the investor claims might conflict with the Trustee's recovery on his fraudulent transfer claims against the feeder funds, the Court held that the automatic stay would not apply. The Court observed that a fraudulent transfer claim is dependent on a finding of the debtor's fraud, while the legal bases for the investors' class actions, which consisted largely of claims under federal securities statutes, were independent of any liability of Madoff or BLMIS for fraud and wholly dependent on the fraud of the managers of the non-debtor feeder funds.⁶⁷ The class actions therefore were not disguised fraudulent transfer claims, and they did not seek property of the estate. Consequently, the stay did not apply.

In the other Madoff case, *Sec. Inv. Prot. Corp. v. BLMIS*,⁶⁸ in accordance with Sections 548(c) and 550(a)(2) of the Bankruptcy Code, and relying on securities laws policies regarding marketplace stability and investor confidence, the Court ruled that the Trustee must sufficiently plead a transferee's lack of good faith in order to survive a motion to dismiss in a SIPA proceeding.

Sections 548(c) and 550(b) provide defenses in fraudulent transfer actions to good faith transferees who meet certain other requirements, but do not define "good faith."⁶⁹ The Court rejected the Trustee's argument that the defendants "failed to act in good faith because they were aware of suspicious circumstances that should have led them to investigate the possibility of . . . fraud," and held that "in a SIPA proceeding such as this, a lack of 'good faith' requires a showing that a given defendant acted with 'willful blindness' to the truth," that is, he 'intentionally [chose] to blind himself to the 'red flags' that suggest a high probability of fraud."⁷⁰ "The Trustee's approach," noted the Court, "would impose a burden of investigation on investors totally at odds with the investor confidence and securities market stability that SIPA is designed to enhance. . . ."⁷¹

The decision will affect hundreds of fraudulent transfer actions pending or to be brought by the Trustee, for which parties doubt the Trustee possesses the necessary evidence to adequately plead a lack of good faith.

66. 762 F.3d 199 (2d Cir. 2014). Co-author David L. Barrack represents Ralph C. Dawson, as Receiver for appellee Ascot Partners, L.P., in this case.

67. *Id.* at 208-211.

68. 516 B.R. 18 (S.D.N.Y. 2014).

69. *Id.*

70. *Id.* at 21, quoting *Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011).

71. *Id.* at 22.

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- B. MAKE-WHOLE PREMIUMS AND INTEREST RATES IN CHAPTER 11: *IN RE MPM SILICONES, LLC*, CASE NO. 14-22503 (BANKR. S.D.N.Y. SEPTEMBER 9, 2014)

This bench ruling on a Chapter 11 plan of reorganization is noteworthy because the Court held that the debtors were not required to pay senior noteholders a make-whole premium provided for in their notes and that the debtors could satisfy the cramdown provisions of Bankruptcy Code Section 1129(b) without providing a market rate of interest.

The holders of \$1.0 billion of First Lien Notes and \$250 million of so-called 1.5 Lien Notes were oversecured and asserted that they were entitled to a “make whole” premium—a type of call provision on a bond allowing the borrower to pay off remaining debt prior to maturity subject to payment of the premium—in addition to unpaid principal and accrued interest. The noteholders objected to confirmation of the plan, arguing they were entitled to receive the make-whole payments and that their treatment under the plan, which denied them the payments, was not “fair and equitable” as required by Section 1129(b) of the Bankruptcy Code.

1. *Make-Whole Provisions*

The Court held that the noteholders were not entitled to receive make-whole payments because the indentures did not expressly provide for the make-whole premium upon the automatic acceleration of debt as a result of a bankruptcy filing. The Court further held that by agreeing to the automatic acceleration provision in the indentures, the noteholders had voluntarily forfeited their right to the make-whole premium based on the debtors’ bankruptcy filing. The Court left open the possibility that a future agreement might provide for a make-whole payment as part of a bankruptcy claim, but stated that this language must be expressly set forth in the contract.

The Court also dismissed the argument that the noteholders should be able to decelerate the notes and thus increase their bankruptcy claim. While liquidating a securities contract is permissible under Section 555 of the Bankruptcy Code notwithstanding the automatic stay under Section 362(a), in the Court’s view it was doubtful that the indenture itself is a securities contract under Section 741(7)(A) of the Bankruptcy Code, and deceleration of the notes to permit the increase of a claim against the debtors through the make-whole premium is not a “liquidation” as contemplated by Section 555.

2. *Below Market Interest Rate*

The Court rejected the noteholders’ assertion that their plan treatment was not fair and equitable because the interest rate was below market and therefore, did not satisfy Section 1129(b) of the Bankruptcy Code. Its decision focused on two cases: *Till v. SCS Credit Corp.*, and *In re Valenti*, both of which analyzed the proper interest rate to apply to replacement notes distributed to secured creditors under Chapter 13 of the Bankruptcy Code, which contains a cramdown provision substantially similar to that in Chapter 11.⁷² In *Till*, a plurality of the U.S. Supreme Court held that the cramdown interest on replacement

72. *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004); *In re Valenti*, 105 F.3d 55 (2d Cir. 1997).

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notes should be the “formula” method, which is calculated by using the prime rate and adjusting upward to reflect credit and collateral risk. Courts applying this method typically set a risk premium of between 1.0% and 3.0% over the prime rate. In Footnote 14 in *Till*, however, the plurality opinion stated that the cramdown interest in a Chapter 11 might be calculated differently because, unlike the Chapter 13 context, there was a free market of willing cramdown lenders and thus it “might make sense to ask what rate an efficient market would produce.”⁷³

The Court in *MPM* determined that no such effective market of willing cramdown lenders existed in that case. The Court then adopted the *Till* formula approach for calculating the interest rate on the replacement notes but held that, as in *Till*, the prime rate, not the treasury rate, was the appropriate benchmark. It thus extended the Supreme Court’s reasoning in *Till* from Chapter 13 cramdown rates to Chapter 11 cramdown rates, which the Court stated should likewise “not contain any profit or cost element.”

While *MPM* illustrates the requirement for careful drafting if lenders plan to argue for a make-whole payment, it concludes that such payments constitute unmatured interest and are not allowable in bankruptcy cases in any event. It also rejects an expansive view of what constitutes a “liquidation” and a “securities contract” under Sections 555 and 741 of the Bankruptcy Code, respectively. *MPM* also stands as further authority extending the cramdown interest rate analysis of *Till* to the Chapter 11 context.

The *MPM* ruling is currently on appeal.

73. *Till v. SCS Credit Corp.*, 541 U.S. 465, 476 (2004).

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